ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Ashburn | Analyst: Marion Mann DeJong | Bill Number: AB 1315

Related Bills: AB 539 (1997/1998) See Legislative History | Telephone: 845-6979 | Introduced Date: 02/26/1999

Attorney: Doug Bramhall | Sponsor:

SUBJECT: Manufacturers' Investment Credit/Affiliated Corporations Who File Combined Reports

SUMMARY

Under the Bank and Corporation Tax (B&CT) law, this bill would modify the definition of "qualified taxpayer" for purposes of the Manufacturers' Investment Credit (MIC) to include affiliated corporations that file a single combined report if one or more of the affiliates is a qualified taxpayer and would allow the credit against the tax liability of the combined group rather than the tax liability of the affiliate that earned the credit.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would apply to taxable or income years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

SB 671 (Stats. 1993, Ch. 881); SB 676 (Stats. 1994, Ch. 748); SB 38 (Stats. 1996, Ch 954.); SB 1106 (Stats. 1997, Ch. 604); AB 2798 (Stats. 1998, Ch. 323).

SPECIFIC FINDINGS

Existing state law, under the B&CTL, requires unitary corporations with activities both within and outside California to combine all activities when determining business income apportionable to the state for tax purposes. Under the worldwide unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of the income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales. The California income is then apportioned to the members taxable in California, which retain separate tax identities and liabilities.

The B&CTL allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources.

The B&CTL also allows the Franchise Tax Board (FTB) to permit or require the determination of California tax liability by use of the unitary method. A combined report is used by two or more taxpayers controlled directly or indirectly by the same interests to determine the amount of income subject to tax by each taxpayer in the group. Only unitary corporations that are at least 50% commonly owned file combined reports. Brother-sister corporations as well as parent-subsidiary corporations may file a combined report, and foreign corporations must be included if they are unitary, unless a valid water's-edge election is in effect.

Board Position:			Department Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR		
____ N	____ OUA	X PENDING	**Gerald Goldberg**	**4/2/1999**

The B&CTL provides for the use of an apportionment formula when assigning business income of multistate and multinational corporations to California for tax purposes. For most corporations, this formula is the average of the factors of property, payroll and double-weighted sales. Each factor is the ratio of in-state activity to worldwide activity. The combined report is not a tax return; it is used to determine the apportionment percentage and the amount of income attributable to California. Generally, each California taxpayer included in the combined report must file its own tax return using Form 100. However, some unitary groups may elect to file a group Form 100 and report the sum of the separate tax liabilities of the unitary members. Unlike taxpayers that file a federal consolidated return, a taxpayer within the combined report is not jointly and severally liable for the tax liability of every taxpayer within the combined report group.

Existing state law allows taxpayers to use various credits against tax. General rules are provided in the law with respect to the sharing of tax credits. Unless a credit provision specifies some other sharing arrangement, two or more taxpayers (other than a husband and wife) may share a tax credit in proportion to their respective shares of the creditable costs. Partners may divide a credit in accordance with a written partnership agreement. Generally, members of a unitary group cannot share tax credits; the member that incurred the cost, claims the credit. One exception to this rule is the low-income housing credit. The low-income housing credit allows the taxpayer to elect to transfer the credit between 100% owned affiliated corporations, since the affiliate that incurs the costs eligible for the credit usually incurs rental losses and pays only the minimum franchise tax.

The MIC allows qualified taxpayers a credit equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California. The MIC may be carried over for a maximum of eight years, or ten years for small businesses. The taxpayer must recapture any credit previously allowed if the property is removed from California, disposed of to an unrelated party or converted to an unauthorized use within one year from the date the property is first placed in service in California.

For purposes of **the MIC**, a qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes in the SIC Manual. Qualified property is any of the following:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code and used primarily:

- for manufacturing, processing, refining, fabricating or recycling of property;
- for research and development;
- for the maintenance, repair, measurement, or testing of otherwise qualified property; or
- for pollution control which meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) Special purpose buildings and foundations that are an integral part of manufacturing, refining, processing or fabricating, or research and storage facilities that are part of the process, which are used by qualified persons performing manufacturing activities described in specific codes relating to computer, accounting, and office machines, electronic equipment and accessories, biotech or biopharmaceutical activities, semiconductor equipment manufacturing activities and certain aerospace manufacturing activities.

For taxpayers engaged in computer programming and computer software related activities, qualified property includes (1) computers and computer peripheral equipment used in those businesses primarily for the development and manufacture of prepackaged software or custom software prepared to the special order of the purchaser who uses the program to produce and sell or license copies of the program as prepackaged software, and (2) the value of any capitalized labor costs directly allocable to the construction or modification of such property.

This bill would modify the definition of "qualified taxpayer" for purposes of the MIC to include affiliated corporations that file a single combined report if one or more of the affiliates is a qualified taxpayer and would allow the credit against the tax liability of all members of the combined group rather than the tax liability of the affiliate that earned the credit.

Policy Considerations

This bill would raise the following policy considerations.

- Currently, affiliates that file a combined report retain a separate tax identity and liability. Generally, items such as net operating loss carryovers and credits are not shared among the members of the combined group. For example, under current law, if one member of a combined group incurs costs that qualify for a tax credit, but has insufficient tax liability to utilize that credit, any unused amount is carried over to future tax years, but is not applied to the tax liability of any other taxpayer. This bill would provide an exception to this policy.

- This bill does not provide a method for apportioning the MIC to affiliated members. Some who have supported the policy of combined group use of credits have done so using the rationale that the investment which gave rise to the credit is economically a group investment. That rationale would support apportionment of credits to all members of the combined group, even those not California taxpayers.

- If tax policy is changed to allow the MIC to be applied against the tax liability of other members of the combined group, perhaps similar policy should be considered for all credits.

- This bill would allow a credit to taxpayers that did not incur the cost on which the credit is based, thus providing a benefit for the action of another taxpayer.

- By treating affiliated corporations as qualified taxpayers, even if not engaged in specified lines of business otherwise eligible for the MIC, this bill can be viewed as extending a manufacturing based credit to otherwise non-qualified taxpayers.

Implementation Considerations

This bill would raise the following implementation concerns. Department staff is available to assist the author with any necessary amendments.

- This bill defines each member of a combined report as a qualified taxpayer. However, the bill still requires that the credit be based on costs paid or incurred by the qualified taxpayer for specified property. The bill could be interpreted as requiring any member who is otherwise a qualified taxpayer to have paid qualified costs.

- This bill allows the credit to be applied against the “combined tax liability of the combined group.” Affiliated corporations do not have a “combined tax liability”; each affiliate retains a separate tax identity and liability. Unless specific language to implement this policy is developed, it is unclear how this bill should be implemented.

- It is unclear how the MIC recapture provision would work. Would the affiliate that claimed the credit or the affiliate that actually placed the property in service recapture the credit if the property is removed from service?

- It is unclear how an allowed, but unused, MIC would be carried forward to future years, particularly if there are changes in the identity of the combined group. For example, the entity originally generating the MIC could leave the group after the first year, and it is unclear how the carryover amount would be allocated in this situation.

- If audit results modify an affiliated group’s composition, it is not clear how an allocated credit should be reallocated.

FISCAL IMPACT

Departmental Costs

If this bill were amended to resolve the implementation considerations, this bill would not significantly impact the department's cost.

Tax Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Estimated Revenue Impact of AB 1315 February 26, 1999 Effective 1/1/99, Enacted after 6/30/99 $ Millions		
1999-0	2000-1	2001-2
($30)	($38)	($40)

This estimate does not account for any change in personal income, employment, or gross state product, which may result from this bill.

Tax Revenue Discussion

The revenue impact of this bill would depend on the amount of manufacturers' credit that is being carried over by subsidiaries and the liability of all other members of the combined group.

This estimate was developed from an analysis of a sample of returns filed for the 1995 income year. From the 1995 inventory of unused manufacturers' credit, approximately 13% of the total is accounted for by subsidiary companies which reduced their liability to zero, but still had unused credits. Examining the liabilities of other members of the combined groups revealed that about 40% of that amount could have been applied against the liability of other members of the group.

BOARD POSITION

Pending.